STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**04/13/05**	Bill No:	**AB 1580**
Tax:	**Sales and Use**	Author:	**Torrico**
Related Bills:	**AB 80 (Houston)** **AB 344 (Villines)** **AB 845 (Ridley-Thomas)** **SB 552 (Alquist)** **SB 631 (Dutton)**		

BILL SUMMARY

This bill would provide a state sales and use tax exemption (5.25%) for purchases of qualifying tangible personal property by qualified persons primarily engaged in specified activities, including manufacturing, construction contracting, software production, telecommunications, cable distribution, scientific research and development services, and wholesale distribution of recyclable materials.

The bill would postpone the above exemption until after an unspecified date, and would allow qualifying purchasers to claim refunds for the equivalent amount of tax paid during the period of postponement.

Summary of Amendments

The amendments to the previous version of the bill delete the provisions that would have included an optional local tax component within the proposed exemption.

ANALYSIS

Current Law

Under current law, entities engaged in activities such as manufacturing, research and development, telecommunications, and construction contracting that make purchases of equipment and other supplies for use in the conduct of their activities are required to pay tax on their purchases to the same extent as any other person either engaged in business in California or not so engaged. Other than for construction contractors, current law does not provide special tax treatment for these entities.

The Board's Regulation 1521, *Construction Contractors*, provides specific guidelines on a contractor's responsibilities under the Sales and Use Tax Law. Construction contractors are persons who erect, construct, alter, or repair any building or other structure, project, development, or other improvement on or to real property. In general, construction contractors are the consumers of the materials and retailers of the fixtures they furnish and install in the performance of a construction contract. As consumers, contractors are required to pay tax on their cost of the materials used in the course of the project. As retailers of fixtures, contractors are regarded as retailers, and tax applies to their sales of the fixtures.

"Materials" means construction materials and components, and other tangible personal property incorporated into, attached to, or affixed to, real property by contractors in the performance of a construction contract and which, when combined with other tangible personal property, loses its identity to become an integral and inseparable part of the real property. Typical items regarded as materials include asphalt, linoleum, steel, bricks, cement, and wallboard, and insulation.

"Fixtures" means items that are accessories to a building or other structure and do not lose their identity as accessories when installed. Items such as air conditioning units, lighting, burglar and fire alarms, cabinets, counters, elevators, electric generators, and plumbing hardware are typically regarded as fixtures.

Proposed Law

This bill would add Section 6377 to the Sales and Use Tax Law to provide an exemption operative January 1, 2006, for the following purchases by a "qualified person":

- Tangible personal property to be used 50 percent or more in any stage of manufacturing, processing, refining, fabricating, or recycling of property (i.e., machinery, equipment belts, shafts, computers, software, pollution control equipment, buildings and foundations).
- Tangible personal property purchased for use in research and development.
- Tangible personal property necessary to create or deploy an Internet connection with minimum downstream speeds of 128 Kilobits per second.
- Tangible personal property purchased to be used 50 percent or more in maintaining, repairing, measuring, or testing any exempt manufacturing equipment.
- Tangible personal property purchased for use by a contractor for use in a construction contract for a "qualified person" who will use that tangible personal property a an integral part of the manufacturing, processing, refining, fabricating, recycling, or as a research or storage facility.

The bill would define a "qualified person" as any person engaged in activities, described in various sectors of the North American Industry Classification System Manual (NAICS), or an affiliate, as specified, as follows:

- Codes 3111 to 3399 – Manufacturing, which includes all manufacturers, with the exception of food manufacturing (Code 311)
- Code 237 - Heavy and Civil Engineering Construction, which is comprised of establishments whose primary activity is the construction of entire engineering projects (e.g., highways and dams), and specialty trade contractors, whose primary activity is the production of a specific component for such projects. Specialty trade contractors in "Heavy and Civil Engineering Construction" generally are performing activities that are specific to heavy and civil engineering construction projects and

are not normally performed on buildings. The work performed may include new work, additions, alterations, or maintenance and repairs.

- Code 238 - Specialty Trade Contractors, which is comprised of establishments whose primary activity is performing specific activities (e.g., pouring concrete, site preparation, plumbing, painting, and electrical work) involved in building construction or other activities that are similar for all types of construction but that are not responsible for the entire project. The work performed may include new work, additions, alterations, maintenance, and repairs. The production work performed by establishments in this subsector is usually subcontracted from establishments of the general contractor type or operative builders but, especially in remodeling and repair construction, work also may be done directly for the owner of the property. Specialty trade contractors usually perform most of their work at the construction site, although they may have shops where they perform prefabrication and other work. Establishments primarily engaged in preparing sites for new construction are also included in this subsector.
- Code 5171 - Wired Telecommunications Carriers, which is comprised of establishments primarily engaged in operating, maintaining or providing access to facilities for the transmission of voice, data, text, sound, and video using wired telecommunications networks. Transmission facilities may be based on a single technology or a combination of technologies.
- Code 5172 - Wireless Telecommunications Carriers (except Satellite), which is comprised of establishments primarily engaged in operating, maintaining or providing access to facilities for the transmission of voice, data, text, sound, and video using wireless telecommunications networks. Transmission facilities may be based on a single technology or a combination of technologies.
- Code 5173 - Telecommunications Resellers, which is comprised of establishments primarily engaged in purchasing access and network capacity from owners and operators of the networks and reselling wired and wireless telecommunications services (except satellite) to businesses and households. Establishments in this industry resell telecommunications; they do not operate and maintain telecommunications switching and transmission facilities.
- Code 5175 - Cable and Other Program Distribution, which is comprised of establishments primarily engaged as third-party distribution systems for broadcast programming. The establishments of this industry deliver visual, aural, or textual programming received from cable networks, local television stations, or radio networks to consumers via cable or direct-to-home satellite systems on a subscription or fee basis. These establishments do not generally originate programming material.
- Code 423930 - Recyclable Material Merchant Wholesalers, which is comprised of establishments primarily engaged in the merchant wholesale distribution of automotive scrap, industrial scrap, and other recyclable materials. Included in this industry are auto wreckers primarily engaged in dismantling motor vehicles for the purpose of wholesaling scrap.

- Code 5112 - Software Publishers, which includes establishments primarily engaged in computer software publishing or publishing and reproduction. Establishments in this industry carry out operations necessary for producing and distributing computer software, such as designing, providing documentation, assisting in installation, and providing support services to software purchasers. These establishments may design, develop, and publish, or publish only.
- Code 5417 - Scientific Research and Development Services, which is comprised of establishments engaged in conducting original investigation undertaken on a systematic basis to gain new knowledge (research) and/or the application of research findings or other scientific knowledge for the creation of new or significantly improved products or processes (experimental development). The industries within this industry group are defined on the basis of the domain of research; that is, on the scientific expertise of the establishment.

The bill would specify that the proposed exemption would *not* include 1) tangible personal property that is used primarily in administration, general management, or marketing, 2) consumables with a normal useful life of less than one year, except for fuels used in the manufacturing process, and 3) furniture, inventory, equipment used in the extraction process, or equipment used to store finished products that have completed the manufacturing process.

The bill would postpone the exemption until an unspecified date, and would allow purchasers to claim refunds equal to the amount of tax paid on qualifying property from period January 1, 2006 until the postponement period ends.

As a tax levy, the bill would become effective immediately upon enactment.

Background

For a ten-year period ending December 31, 2003, the law provided a state sales and use tax exemption for purchases of equipment and machinery by new manufacturers, and income and corporation tax credits for existing manufacturers' investments (MIC) in equipment. Manufacturers were defined in terms of specific federal “Standard Industrial Classification" (SIC) codes. The exemption provided a state tax portion exemption for sales and purchases of qualifying property, and the income tax credit was equal to 6% of the amount paid for qualified property placed in service in California. Qualified property essentially was depreciable equipment used primarily for manufacturing, refining, processing, fabricating or recycling; for research and development; for maintenance, repair, measurement or testing of qualified property; and for pollution control meeting state or federal standards. Certain special purpose buildings were included as "qualified property."

This sales and use tax exemption and income tax credit had a conditional sunset date. They were to sunset in any year following a year when manufacturing employment (as determined by EDD) did not exceed January 1, 1994 manufacturing employment by more than 100,000. On January 1, 2003, manufacturing employment (less aerospace) did not exceed the 1994 employment number by more than 100,000 (indeed, it was

LESS than the 1994 number by over 10,000), and therefore the MIC and partial sales tax exemption sunsetted at the end of 2003.

The manufacturer's sales and use tax partial exemption for new manufacturers and the corresponding income tax credit for existing manufacturers were added in 1994 by SB 671 (Stats. 1993, Ch. 881). The purpose of that legislation was to enable California to become competitive with the 42 other states that exempted manufacturing equipment and were luring manufacturers away from California with promises of lower taxes. SB 671 was designed to provide California companies with an immediate incentive to expand their facilities and to create new jobs.

In an October 2002 report put out by the Legislative Analyst's Office, *An Overview of California's Manufacturers' Investment Credit*, the following arguments against and in support of these tax incentives were presented:

Arguments Supporting the MIC

- Investment Incentive—The MIC effectively reduces the price of new capital, and leads to greater investment. Adherents of this view suggest that a firm considering a capital investment is much more likely to undertake such investment with the MIC in place. Proponents argue that this marginal cost reduction can have a significant positive impact on investment decisions.
- Relocation Incentive—California has become a more attractive place relative to other states for business since the credit has been in place. The argument here is that tax credits do influence corporate location decisions and dissuade businesses from moving their activities out of California. Manufacturing industry representatives stated and continue to state that the MIC plays an important role in both expansion and business location decisions.
- Efficient Job Allocator—Competition for business among states is an efficient job allocator. This argument holds that the nation benefits from the redistribution of jobs that may occur due to the use of investment tax credits. This is based on the notion that jobs are worth more in areas with higher unemployment, and that such areas are likely to have relatively aggressive tax credit programs. These areas will be able to attract businesses away from regions that do not value the jobs as highly.
- Other Arguments. Advocates of the MIC also emphasize that the MIC offers significant indirect benefits to the state in terms of investment and job growth that result in additional state revenues. They also point out the importance of manufacturing to the overall state economy in terms of economic stability and the high value-added nature of the employment in this sector.

Arguments Against the MIC

- Inequitable Taxation—The MIC results in giving a tax advantage to manufacturing over other business activities, as well as providing an advantage to capital investment over labor. This view holds that since only one type of industry (and production factor) benefits from the tax credit, the remaining industries face relatively higher costs, and are therefore at a competitive disadvantage. Such preferential treatment can also result in inefficient resource allocation according to this view.

- Relocation Rather Than Creation—The MIC results in few new jobs, but rather pits states against each other in competing for jobs. The argument here is that corporate tax breaks are no more than a transfer of government funds to private businesses, and in the end, the national economy is unaffected. In this view the competition among states in offering various tax incentives represents a form of "prisoners' dilemma"—in which each state would be better off if none offered such incentives. If one state does offer them, however, it is in the interest of other states to do the same.
- Inefficient Development Policy—Tax incentives have a negligible impact on economic growth, and any job creation that does occur does so at a substantial cost per job. Proponents of this view also hold that some of the tax credits will go to companies which would have made the same investments, regardless of the tax incentive. That is, the tax credit did not induce the investment, yet the company receives "windfall benefits" in the form of reduced taxes.
- Ineffective Development Policy—Taxes are a very small percentage of overall business costs and thus have little effect on business decisions. Labor, transportation, land, and other factors typically constitute much more significant proportions of total costs than do taxes. Therefore, according to those who hold this view, tinkering with this particular cost is unlikely to result in a large shift or expansion of business compared to the adverse fiscal effects that such measures can have on the state.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the California Manufacturing and Technology Association. Its purpose is to provide an incentive for manufacturing production facilities in California. The author's office notes that California is only one of four states in the United States that imposes a double tax on manufactured goods – sales tax is not only imposed on the manufactured product at the final sale, but also on the equipment purchased for use in the manufacturing process. This bill is intended to eliminate this double taxation structure and help return California to its status as a dynamic and competitive manufacturing base.
2. **The proposed exemption would be more complicated to administer than most other exemptions.** This is a broad-based exemption that would be difficult to administer. The taxability of the proposed items to be exempted would hinge on a very specific use to which that item would be put. In auditing purchasers of such items, the Board would be required to verify the use itself, rather than just verifying the type of property purchased (how would we know whether an electrical contractor's purchase of a hammer was purchased for use in constructing a special purpose building). Even with strict definitions or descriptions of the items the bill is intending to exempt, administration of this bill would be difficult. It should also be noted that, due to the broad range of establishments and items proposed to be

exempted, a significant number of retailers making sales to the qualifying purchasers of the property would be affected.

3. **The proposed exemption for purchases by contractors is unclear.** The bill states that specified construction contractors would be considered “qualified persons” for purposes of the proposed exemption. Although the bill would limit the exemption to property used primarily for manufacturing, processing, refining, fabricating or recycling of property, under the definition of “processing”, any contractors’ purchases could be excluded from the computation of tax. “Processing” is defined as the physical application of the materials and labor necessary to modify or change the characteristics of the property. With that, under the bill, contractors could benefit from an exemption from the tax for virtually all materials used in the performance of their contracts – regardless of who the customer is - such as the concrete for a dam, steel for a bridge, lumber for a house, etc. In addition, it appears the language would also provide an exemption for all machinery and equipment used in the performance of their activities. This does not appear to be consistent with the purpose of the bill.

4. **The proposed exemption for scientific research and development services establishments would be limited.** The bill would include scientific research and development service enterprises as “qualified persons” for purposes of the exemption. However, the bill would define “research and development” as those activities that are described in Internal Revenue Code (IRC) Section 174. IRC Code Section 174 enables federal income taxpayers a deduction for qualified research expenses. This section allows a deduction for any research expenditures that are not chargeable to a capital account, and specifically excludes depreciable property as a qualifying deduction. Therefore, it appears these scientific research entities would only be eligible for an exemption on tangible items treated as research expenses (provided they aren’t considered consumables with a normal useful life of less than one year – also excluded under this bill), rather than on any capital equipment or depreciable property. Is this the author’s intent?

5. **Qualifying persons should be engaged *primarily* in the activities to benefit from the proposed exemption.** The bill would extend the exemption to any qualified person engaged in the described activities. However, the bill doesn’t require that the qualified person be primarily so engaged. This could be interpreted to mean that the exemption would be extended to purchases of qualifying items by any entity engaging even minimally in the activities described. This would not only drastically complicate administration of the provisions, but would also substantially increase the associated revenue losses. It is recommended that the bill require that the qualified person be primarily (over 50%) engaged in the activities described.

6. **Why create an exemption now?** A sales and use tax exemption, by its nature, is claimed at the time the purchase is made. Generally, the purchaser (as, for example, a manufacturer) issues an exemption certificate to the retailer at the time the purchase order is issued, which allows the retailer to delete the applicable tax from the sale. The retailer then reports the exempt sale on his or her return for the reporting period in which the sale was made. It would seem more appropriate to

create the exemption on a prospective basis only, rather than allowing purchasers to claim refunds at a later date.

7. **Sales tax refunds are generally allowed only to persons who actually paid the tax to the Board.** Current law provides that an overpayment of sales tax to the Board shall only be refunded or credited by the Board to the person who actually paid the tax to the state. Therefore, if a customer paid sales tax to a retailer on an amount which should not have been subject to the tax, or paid sales tax in excess of the amount of tax due, the law provides that such an overpayment can only be claimed by the retailer who actually paid the tax to the state. The refund is issued by the Board directly to the retailer, with the condition that the refund be passed on by the retailer to the person from whom the tax was collected. Generally, the Board has no authority to refund the sales tax to someone other than the person who paid the tax to the state.

   There is a practical reason why the law prohibits a person who has not paid the sales tax to the Board to claim a refund directly from the Board. It ensures a safeguard against the possibility of issuing a tax refund twice on the same transaction. Without this safeguard, the opportunity for both the retailer and the person who paid tax to the retailer to file a claim for refund would be available, thereby increasing the possibility of duplicate refunds being issued. As drafted, this measure would deviate from this safeguard by enabling either the purchaser or retailer to claim a refund.

8. **Technical issues.**
   - ***The NAICS Code references are confusing.*** For purpose of defining a "qualified person," the bill makes reference to various NAICS codes. However, these references are confusing. Code 237 as referenced in the bill is the major sector covering all heavy and civil engineering construction. Code 2371 (also listed in the bill for purposes of identifying a "qualified person") is a subsector of 237 for utility system construction, and Code 237130 is a subsector of 2371 describing power and communication line and related structures construction. Other references in the bill have similar problems. If the author intends that all establishments in the major sectors be included, only those major sector code numbers need be included. Alternatively, if the author intends that only the specific subsectors be included, the bill should reflect only those specific subsector references.

   - ***Leased property would have a limited exemption.*** Subdivision (g) (page 7, line 1) provides for an exemption from tax for specified leases of qualified property and limits this exemption for a six-year period. This limitation is modeled after a provision in former Section 6377 that provided a state tax exemption solely to *new* manufacturers' leases of equipment. Since this bill would provide the exemption for all qualifying persons, it appears the limitation in subdivision (g) is unnecessary and should be stricken. Otherwise, long-term leases of qualifying property would not enjoy the same tax privileges that the bill would provide to actual purchases of the same property.

- ***Bill should define "useful life."*** Although the Board administered former Section 6377 for a 10-year period, some ambiguities in the statute caused confusion and perhaps should be addressed with the enactment of this measure. For example, on page 5, lines 10 and 24, the bill refers to the items having a useful life of one year or more (or less). In order to lessen potential audit disputes, the bill should contain some mechanism for determining the useful life. Perhaps some reference to the provision in the California income tax laws for depreciating assets should be incorporated into the bill.

9. **Related measures.** Other measures that would provide an exemption for manufacturing activities and other related activities include:

- AB 80 (Houston) would, beginning on the first January following the fiscal year in which the state budget deficit for the 2005-06 fiscal year is eliminated, provide a state sales and use tax exemption (5.25%) for purchases of qualifying tangible personal property by qualified persons primarily engaged in manufacturing, telecommunications and electrical generation activities.
- AB 344 (Villines) would provide a state sales and use tax exemption (5.25%) for purchases of qualifying tangible personal property by qualified persons primarily engaged in manufacturing, telecommunications and electrical generation activities, as specified. The partial exemption would apply to 25% of the sales or purchases for 2006, 50% for 2007, and 100% thereafter.
- AB 845 (Ridley-Thomas) would reinstate the manufacturer's exemption but provide a conditional sunset date depending on the growth in employment and limit the exemption based on the manufacturers' aggregate gross assets. AB 845 would also include manufacturers other than new establishments.
- SB 552 (Alquist) would provide a state and local sales and use tax exemption for purchases of materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, and telecommunications, but would provide that, beginning on January 1, 2006, taxpayers would be able to accrue credits on their purchases that may be redeemed during the first fiscal year of the state budget when state revenues match expenditures.
- SB 631 (Dutton) would reinstate the manufacturers' exemption and income tax credit, and would broaden that exemption to include purchases of equipment by electrical generators.

COST ESTIMATE

The Board would incur significant costs to administer this measure. These costs would be attributable to, among other things, identifying and notifying qualifying entities, auditing claimed amounts, reviewing and processing a potentially voluminous number of claims for refund, revising sales tax returns, and programming. An estimate of these costs is pending.

REVENUE ESTIMATE

Current annual purchases of qualified equipment as defined in this measure are estimated as follows:

NAICS Code	Sector	Expenditures (in millions)
3111-3399	Manufacturing	$19,900.0
5417	Research & Development	$709.0
5171, 517110	Wired Telecommunications	$3,565.0
5172, 517212	Wireless Telecommunications	$1,616.0
5173, 517310	Telecommunications Resellers	$546.0
5175, 51751, 517510	Cable and Other Program Distribution	$670.0
5112	Software Publishers	$798.0
238, 2382, 23821, 238210	Specialty Trade Contractors	$1,575.0
237, 2371, 237130	Heavy and Civil Engineering Construction	$1,420.0
423930	Recyclable Material Merchant Wholesalers	$24.0
	Total	$30,823.0

Revenue Summary

The annual revenue loss from exempting $30.8 billion from the state sales and use tax is estimated to be $1.6 billion ($30.8 billion X 0.0525).

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